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SUBJECT: UKRAINE'S NEXT STEP TOWARD THE EU: A "DEEP" FREE
TRADE AGREEMENT

REFS: A) KYIV 1860
B) KYIV 1330
C) KYIV 915
D) 2007 KYIV 1862

11. (SBU) Summary: Ukraine and the EU have launched negotiations on a Free Trade Agreement (FTA), which would slash bilateral tariffs and reduce a range of other non-tariff trade barriers. Ukraine's chief negotiator told us that the talks are not true "negotiations," as they are focused on how Ukraine can best adapt its economy to existing EU norms. Many on the EU side see the FTA as a way to bring Ukraine as close to Europe as possible without EU membership, which is not on the EU agenda at the moment because of "enlargement fatigue." Once completed, the FTA should significantly increase EU-Ukraine trade and boost Ukrainian economic growth. The GOU strongly supports the FTA negotiations, although warns that a few areas, such as environmental issues and government procurement, could prove difficult to resolve. The influential Party of Regions also supports an FTA, but less vigorously. A few large Ukrainian businesses publicly support the FTA, but there is a lack of knowledge more broadly among the business community, and some companies are worried the FTA could hurt trade with Russia. Post believes that an EU-Ukraine FTA is strongly in the U.S. national interest, as it is a further step anchoring Ukraine in Euro-Atlantic institutions. We recommend that the USG support the EU-Ukraine negotiations in every appropriate manner. End Summary.

FTA Talks Launched

12. (U) Ukraine and the European Union (EU) officially launched negotiations on a Free Trade Agreement (FTA) with much fanfare on February 18, shortly after members of the World Trade Organization (WTO) agreed to the terms of Ukraine's accession to the WTO. Substantive discussions began in April, with follow-on meetings occurring every two or three months. The last round of negotiations took place July 7-11 in Kyiv, with the next round expected in October.

13. (U) An FTA was long viewed both by Kyiv and Brussels as the logical next-step in their trade relationship after WTO accession, which occurred on May 16 (ref C). (Note: Post continues to work on a handful of WTO accession commitments

that remain outstanding (ref B and previous). End note.)
The FTA will serve as a central pillar of a New Enhanced Agreement between the EU and Ukraine. Some experts point to macroeconomic models showing that trade flows between Ukraine and the EU could double as a result of the agreement, and GDP could grow by an additional four or five percent in the medium term.

"Deep" FTA - Not Just Tariffs

14. (SBU) The most palpable feature of the future FTA will be a drastic reduction in tariffs between the EU and Ukraine. Luis Portero-Sanchez, head of the Trade Section at the EU Commission's office in Kyiv, told a meeting of the European Business Association in May that the EU hoped to eliminate tariffs for almost all goods, although a few -- ideally less than five percent of all tariff lines -- would likely be left outside the agreement. Portero-Sanchez noted that no sector would be excluded a priori. (Comment: We would expect agricultural products to lead the list of goods not included under the FTA. End Comment.) Portero-Sanchez said that the EU wanted maximum liberalization immediately upon signing the agreement, but will be open to transition periods for lowered tariffs, likely of up to five years, on particularly sensitive goods. Olga Shumylo, responsible for FTA negotiations within Deputy Prime Minister Hryhoriy Nemyrya's office, told Econoff on August 27 that the EU had already agreed to allow transition periods for reductions of some Ukrainian import tariffs.

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15. (U) Although lowered tariffs will perhaps be the most visible element of the FTA, there is also widespread agreement that it must be a "deep" FTA (or "FTA Plus"), that is, an agreement that not only lowers tariffs but also reduces a myriad of non-tariff barriers. In the words of an official EU Commission statement, "the FTA will build on the liberalisation undertaken as part of WTO membership and work towards 'deep convergence' -- not just cutting tariffs but addressing red tape for exporters by aiming for similar regulatory standards and norms in both economies."

16. (SBU) Deputy Minister of Economy Valeriy Pyatnytskiy, who was Ukraine's lead trade negotiator for much of the WTO accession process and is continuing in that role for the FTA negotiations, noted to Econoffs in July that talks with the EU would not be "normal" negotiations. Instead, the vast majority of issues would require Ukraine to bring its domestic practices into alignment with EU rules. Ukraine would have little room to negotiate, said Pyatnytskiy.

Battling Ukraine's Oppressive Bureaucracy

17. (SBU) As we saw with Ukraine's tortuous 14-year WTO accession process, the greatest obstacles to concluding an FTA will likely be reform of Ukrainian institutions and elimination of non-tariff barriers. Portero-Sanchez identified the following areas as priorities for the EU: reform of Customs procedures; elimination of technical barriers to trade (TBT), especially modernizing standards and testing procedures; reform of sanitary and phytosanitary (SPS) measures; improved enforcement of intellectual property rights; and fairness in government procurement. Portero-Sanchez recognized that the GOU would likely seek concessions on the free movement of people (i.e. visa-free travel to the EU for Ukrainians), but he said the EU would resist any significant movement in this area and did not want the FTA to become a migration agreement. Portero-Sanchez also noted that EU negotiators would seek some commitments from Ukraine on trade-related aspects in the energy sector -- primarily energy transit -- as they did during WTO accession.

¶8. (SBU) Pyatnytskiy argued that, while the agreement should benefit Ukraine's economy overall, some industries would suffer. He specifically pointed to the environmental chapter of the FTA as one that would involve real costs for Ukrainian industry and said a detailed cost/benefit analysis was still needed. Shumylo said the GOU would seek to avoid signing up for much of the environment chapter of the EU *acquis communautaire*.

¶9. (SBU) Vyacheslav Tsymbal, a member of Ukraine's negotiating team at the Ministry of Economy, told Econoff on August 21 that he expected the chapter on government procurement to be particularly difficult to negotiate. Ukraine's government procurement process was still very chaotic (ref D), said Tsymbal, and reform to meet EU standards would likely prove difficult. Elena Scherbakova, who takes the lead on FTA negotiations at the State Department of Intellectual Property, Ukraine's IPR coordinating body, told Econoff on September 11 that she expected geographical indications (GIs) to be another major sticking point.

Setting the Stage for EU Accession?

¶10. (SBU) Supporters of Ukraine's European integration ambitions look to the FTA as a step towards eventual EU accession. Pyatnytskiy commented that he believed the FTA was being used as a kind of pre-accession instrument for Ukraine, given that "enlargement fatigue" among EU members currently prevented any more formal steps toward accession. The FTA would be a tool to push significant changes within Ukraine and prepare the country for EU membership, said Pyatnytskiy.

¶11. (U) Former Polish President Aleksandr Kwasniewski has

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been among the most visible outside supporters of the FTA, visiting Kyiv several times to push the idea and identify it as a key step to EU accession for Ukraine.

GOU Enthusiastic, Party of Regions Less So

¶12. (SBU) Prime Minister Yulia Tymoshenko and President Victor Yushchenko have made several public statements strongly supporting the FTA negotiations. Deputy Prime Minister Hryhoriy Nemyrya has taken the role of main advocate and coordinator of the FTA within the government. Shumylo told Econoff that DPM Nemyrya was forced to abandon plans to create a separate European Integration Agency in the face of strong resistance from several Ministries, but instead established a bureau under his leadership within the Cabinet of Ministers to coordinate the government's European integration policy. (Comment: Establishing a coordinator at the DPM level should help overcome bureaucratic resistance within the GOU to some elements of the FTA, and marks an improvement from WTO accession negotiations. End Comment.)

¶13. (U) Shumylo also told Econoff that the GOU was actively preparing an analysis of specific areas where Ukraine needed help in negotiating/implementing an FTA, and trying to identify potential donors. The World Bank and the Swedish aid agency SIDA already expressed a willingness to provide some technical assistance, said Shumylo, and the GOU would welcome any potential U.S. assistance.

¶14. (U) Iryna Akimova, Shadow Minister of Economy while the Party of Regions has been in opposition, made clear at a public forum in April that her party supported the FTA and European integration process. But Akimova also used the issue to criticize what she called the government's "populism," arguing that an FTA could not and should not be

finalized until necessary domestic reforms were made, a task that Regions did not find the Tymoshenko government up to. Akimova also made some ambiguous comments on the need for "preconditions" for an FTA, such as macroeconomic stability (an attack on the government over inflation), a balanced budget (an attack on the government's social spending), and improvements in the investment climate (an attack on the government's tax policies), thereby softening Regions' support for an FTA. (Comment: It is not clear how GOU policy might change if Regions were to join Tymoshenko's bloc to form a new ruling coalition (ref A). End Comment.)

Support Among Ukrainian Businesses?

¶15. (U) The Yalta European Strategy (YES), a think tank founded by steel and pipe oligarch Victor Pinchuk, has held a series of public events meant to garner support for the FTA, and for European integration more broadly. Another Ukrainian think tank, the International Centre for Policy Studies (ICPS), has reported that Ukrainian businesses participating in public forums organized throughout the country are largely supportive of an FTA, citing greater market access in the EU as the primary reason. A common concern among businesses, however, was how an EU FTA would affect trade with Russia.

¶16. (U) Shumylo noted that a few large Ukrainian companies, usually major exporters poised to benefit from improved access to EU markets, have already come out in favor of the FTA. For example, Jock Mendoza-Wilson, Director of International and Investor Relations for System Capital Management (SCM), the major financial and industrial group owned by super oligarch Rinat Akhmetov, told Econoff in May that SCM intended to be active in and supportive of the FTA negotiations. SCM was anxious to secure more favorable market access in the EU for its steel exports and viewed deeper integration with Europe as positive for its business plans, as SCM had already acquired a number of large assets in EU countries. Mendoza-Wilson also said that SCM hoped to use the FTA to tap into the EU's internal carbon trading

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system. (Note: He was likely referring specifically to the EU's Greenhouse Gas Emission Trading Scheme (EU ETS). End Note.)

¶17. (SBU) Shumylo commented, however, that there was a real lack of understanding of the FTA process among smaller businesses. The GOU needed to significantly step up its information campaign, said Shumylo, and planned to ramp up consultations with businesses ahead of the next round of FTA negotiations.

Comment: A U.S. Foreign Policy Priority

¶18. (SBU) The conclusion of an EU-Ukraine FTA is strongly in the national interest of the United States. The FTA should serve to improve Ukraine's investment climate, having a positive impact on our bilateral trade and investment relationship. And, most importantly, even though the economic impact on the U.S. economy is likely to be negligible, an EU-Ukraine FTA will be a further step towards integrating Ukraine into Euro-Atlantic institutions. An FTA will help increase economic ties between the EU and Ukraine -- the EU currently accounts for about 30% of Ukraine's total trade, compared to 39% for the CIS and 24% for Russia alone -- and, more critically, force Ukraine to begin meeting EU accession requirements in earnest. The failure of FTA negotiations would cast doubt on Ukraine's future within Europe and could push Ukraine to look eastward in further developing economic ties.

¶19. (SBU) Although we are not a party to this agreement,

the United States should look for every appropriate opportunity to support the EU-Ukraine FTA negotiations. Our support could come in the form of public statements or behind-the-scenes pressure on one or both sides should negotiations stall. We should also consider providing advice or technical assistance to help Ukraine expand its trade negotiation capabilities and its ability to implement trade agreement commitments. Such technical assistance could be modeled after that used successfully during WTO accession, when we provided expert advisers to the GOU. U.S. technical assistance would not involve actual negotiation but would help guide the GOU on how to reform domestic institutions and policies in line with EU requirements. We would want to coordinate with the World Bank and other donors working in this area. Post also requests that the EU-Ukraine FTA remain on the list of issues we raise in our regular dialogue with the EU. End Comment.

TAYLOR